# CLIFFORD CHANCE

# CFTC Bitfinex Enforcement Action

On June 2, the Commodity Futures Trading Commission (the "**CFTC**") issued an order against Hong Kong based cryptocurrency exchange BFXNA Inc. doing business as Bitfinex (the "**Order**"[1], available here) for violating the Commodity Exchange Act (the **"CEA"**). Under the Order, the CFTC accepted Bitfinex's settlement offer, including a civil monetary penalty of USD 75,000. The Order expands the CFTC's regulation of bitcoin and other cryptocurrencies into spot markets under certain conditions.

## Background

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[2] ("**Dodd-Frank**") amended the CEA to add new authority over certain leveraged, margined or financed retail commodity transactions.[3] The Order is the first instance of the CFTC employing this authority to regulate leveraged retail transactions of bitcoins. The Order builds upon the CFTC's September 2015 order against Coinflip (the "**Coinflip Order**",[4] available here), in which the CFTC asserted its jurisdiction over bitcoin as a commodity for the first time, and shows the CFTC is expanding the scope of its jurisdiction in the relatively new and rapidly growing area of fintech beyond the use of cryptocurrencies in derivatives transactions.

The Coinflip Order related to an online platform for bitcoin options.[5] Bitfinex's online platform was for the spot trading of bitcoins.[6] This is significant since the CFTC traditionally regulates commodity-based futures, options, and derivatives and not spot transactions.[7] Bitfinex enabled users to exchange dollars for bitcoins and other cryptocurrencies, and vice versa. They were also able to trade cryptocurrencies for other cryptocurrencies.[8]

Between April 2013 and February 2016, Bitfinex's platform featured margin trading, whereby users could borrow dollars and bitcoins from other users to open leveraged positions on the Bitfinex exchange. The lending users would offer to lend using a tool on the platform, choosing a market rate or their own terms. When an offer was accepted, the borrower could trade the borrowed funds to buy or sell bitcoins for their own account on Bitfinex's exchange. When a borrower's equity in a given position fell below 15% the position would be forcibly liquidated in order to make repayment of the loan. There was a 30% initial margin

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[1]  United States of America Before the Commodity Futures Trading Commission In the Matter of BFXNA Inc. d/b/a BITFINEX, Respondent. 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 (the "**Order**").

[2]  Public Law 111-203, 124 Stat. 1376 (2010).

[3]  Order p. 4.

[4]  United States of America Before the Commodity Futures Trading Commission In the Matter of Coinflip Inc., d/b/a Derivabit, and Francisco Riordan, Respondents. 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, September 17, 2015 (the "**Coinflip Order**").

[5]  Coinflip Order p. 2.

[6]  Order p. 2.

[7]  Mission & Responsibilities, CFTC, http://www.cftc.gov/about/missionresponsibilities/index.htm.

[8]  Order p. 2.

requirement (i.e. a maximum leverage of 3.33-to-1).[9] Bitfinex did not prevent retail customers[10] from margin trading, although a significant portion (88% in 2015) of trading volume came from corporate users.[11] Bitfinex merely administered and enforced the contracts between lenders and borrowers; Bitfinex was never a principal, counterparty or market-maker in any bitcoin trade.[12]

Bitfinex would hold users' bitcoins for their benefit in wallets; in the beginning it was an omnibus settlement wallet. Bitfinex maintained a database to account for each user's bitcoins. Eventually, Bitfinex came to use individually enumerated multi-signature wallets; however, Bitfinex always maintained control over the private keys[13] to the wallets.[14]

# Expansion of CFTC Jurisdiction

The Order is the first time the CFTC has asserted jurisdiction over a bitcoin exchange pursuant to Section 2(c)(2)(D) of the CEA. Section 2(c)(2)(D) provides that any agreement, contract or transaction in any commodity entered into with or offered to a retail customer on a leveraged or margined basis, or financed by the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar basis (each such transaction, a **"financed retail transaction"**) will be regulated by the CFTC and will be subject to the CEA as if it were a contract of sale of a commodity for future delivery. The result is that spot trades qualifying as financed retail transactions will be regulated as if they were futures trades.

Multiple regulatory requirements thus attach to financed retail transactions covered by Section 2(c)(2)(D). All financed retail transactions must be made on or be subject to the rules of a board of trade that has been designated or registered with the CFTC. Certain exceptions exist, including Section 2(c)(2)(D)(ii)(III)(aa) (the **"Exception"**): if such an agreement, contract or transaction would result in actual delivery within 28 days, it will not be regulated as if it were a transaction of a commodity futures contract.

The Order finds that the margin trading on Bitfinex came under Section 2(c)(2)(D) and did not fall under the Exception. The CFTC already found bitcoins to be a commodity in the Coinflip Order, based on the definition of "commodity" in Section 1a of the CEA[15] and citing a 7th Circuit Court of Appeals opinion construing the definition of commodity as "broad[16]". Bitfinex offered financed retail transactions of commodities through the margin trading feature. The transactions were financed retail transactions, triggering Section 2(c)(2)(D) of the CEA since many of the individual users were retail customers and the trades were made on a margined basis.[17]. The Exception does not apply since the bitcoins were not actually delivered. In finding lack of actual delivery, the CFTC looked to the fact that at all times Bitfinex held the private keys needed to access the wallet where bitcoins were held. The CFTC also cited Bitfinex's authority to forcibly liquidate a position when a borrower's equity fell below a given percentage as evidence of no actual delivery.[18]

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[9]  Order p. 2-3.
[10]  Under the CEA "**retail customer**" is a person/entity that is not an eligible commercial entity ("**ECE**") or an eligible contract participant ("**ECP**"). Section 1a(18) of the Act defines an ECE as a person/entity that, *inter alia*, has the ability to take delivery of the commodity, incurs risk related to the commodity and provides risk management services to those who deal in the commodity. Section 1a(17) of the Act defines an ECP as, inter alia, certain highly regulated financial institutions such as a bank, insurance company, or investment company and other persons or entities with a minimum amount of assets, starting at USD 5,000,000 but varying by entity.
[11]  Order p. 3-4.
[12]  Order p. 3.
[13]  In this context the "private key" is a secret number (usually 256-bit number) associated with a deposit wallet that allows bitcoins in that wallet to be spent.
[14]  Order p. 3.
[15]  Section 1a(9) of the Act defines "commodity", listing more than fifteen agricultural products; it further extends the definition to all other goods and articles, with certain exceptions. In relevant part, the definition includes "all services, rights, and interests … in which contracts for future delivery are presently or in the future dealt in."
[16]  Coinflip Order p. 3 (citing Board of Trade off City of Chicago v. SEC, 677 F. 2d 1137, 1142 (7th Cir. 1982)).
[17]  Order p. 5-6.
[18]  Order p. 6.

It should be noted that, while the CFTC considers "actual delivery" to be an unambiguous term, for a digital product like bitcoin, the physical transfer standard used by courts and cited by CFTC[19] is not applicable. Instead, the CFTC explicitly refered to independent depositories as a type of transferee that would satisfy the actual delivery requirement. The CFTC asserted that a transfer of the commodity, including the financed or borrowed portion, to a depository "other than the seller, the seller's parent company, partners, agents, and affiliates"[20] would constitute actual delivery pursuant to an interpretation published by the CFTC in the Federal Register.[21] One rationale for this rule is to ensure the seller actually has the commodity to deliver to the independent depository. While a book entry of a bitcoin transfer alone is not considered sufficient proof of actual delivery,[22] the CFTC's argument implies that transfer of the private keys to the borrower might constitute actual delivery. This can be inferred from the CFTC asserting that moving the bitcoins from an omnibus settlement wallet to individually enumerated wallets was not actual delivery as Bitfinex always held the private keys.[23] Possession of the private key allows bitcoins in a wallet to be spent; without it, the bitcoins remained controlled by Bitfinex.[24]

# Violations of the CEA

After breaking new ground in establishing jurisdiction over financed retail transactions of bitcoins, the Order set forth comparatively uncontroversial violations of the CEA. Bitfinex violated Section 4(a) of the CEA by offering to enter into, executing, and confirming financed retail transactions of a commodity not 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, in this case bitcoin.

Bitfinex also violated Section 4d(a) of the CEA by failing to register as a futures commissions merchant while accepting orders for retail commodity transactions, and receiving funds in connection with those transactions.

# Future Implications

As a general matter, the Order serves as additional evidence of the CFTC's proactive approach in establishing its jurisdiction in regulating cryptocurrencies such as bitcoin. For the second time in less than a year, the CFTC has used an order paired with a "neither admit nor deny" settlement to assert jurisdiction over bitcoin transactions. This is not necessarily a signal, however, that the CFTC wishes to eliminate or stall the trading of bitcoins; rather, any such transactions and participants in bitcoin transactions simply face the same rules as other commodity transactions.[25] Indeed, the CFTC has even provisionally registered a bitcoin swap exchange facility[26].

In cases where there may be a violation, cooperation could be a mitigating factor. Bitfinex made a point of contacting the CFTC even before the Coinflip Order (and therefore, any CFTC enforcement action involving bitcoin) was issued to try to ensure

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[19]   Order p. 5 (citing <u>CFTC v. Hunter Wise Commodities, LLC</u>, 749 F.3d 967, 978-79 (11th Cir. 2014)).

[20]   Order p. 5.

[21]   Retail Commodity Transactions Under Commodity Exchange Act, 78 Fed. Reg. 52,426 (Aug. 23, 2013) (CFTC interpretation regarding the meaning of the term "actual delivery" as set forth in the Act) (http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2013-20617a.pdf).

[22]   Order p.5.

[23]   Order p. 6.

[24]   *See* Supra note 6.

[25]   The CFTC's director of enforcement has said "While there is a lot of excitement surrounding Bitcoin and other virtual currencies, innovation does not excuse those acting in this space from following the same rules applicable to all participants in the commodity derivatives markets." (http://www.cftc.gov/PressRoom/PressReleases/pr7231-15).

[26]   *See CFTC Settles with TeraExchange LLC, a Swap Execution Facility, for Failing to Enforce Prohibitions on Wash Trading and Prearranged Trading in Bitcoin Swap*, CFTC, September 24, 2015, http://www.cftc.gov/PressRoom/PressReleases/pr7240-15

compliance.[27] The CFTC makes note of Bitfinex's extensive and pro-active cooperation in both the Order and the CFTC's accompanying press release.

While this area of law and the CFTC's corresponding jurisdiction will continue to evolve, the Order demonstrates that the CFTC intends to protect and assert its jurisdiction as financial transactions move into new areas and fintech gains ground. The Order has made it clear that the standards for compliance remain at least as high in fintech as they are in all other areas of CFTC regulation.

*Ron Havas contributed to this client briefing.*

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[27]   Order p. 4. "Bitfinex's cooperation with the Commission's investigation was significant. After learning that the Commission was potentially investigating Bitfinex, on September 17, 2015 - which was before the Commission had announced any enforcement action involving bitcoin - Bitfinex affirmatively contacted staff of the Division of Enforcement to offer its cooperation. During the course of the investigation conducted by the Division of Enforcement, Bitfinex consistently responded to requests for information fully and quickly, both in writing and via oral presentations."