

## ***The Crypto Exchange: Crackdown on DeFi? An Examination of the CFTC's Enforcement Action Against Uniswap***

**Host: Ethan Ostroff**

**Guest: Addison Morgan**

**Ethan Ostroff:**

Welcome to another episode of [The Crypto Exchange](#), a Troutman Pepper Podcast, focusing on the world of digital assets. I'm Ethan Ostroff, the host of this podcast, and a partner here at Troutman Pepper. Before we jump into today's episode, let me remind you to visit and subscribe to our blogs, [ConsumerFinancialServicesLawMonitor.com](#) and [TroutmanPepperFinancialServices.com](#). Don't forget to check out our other podcasts on [troutman.com/podcasts](#).

Today I'm joined by my colleague, Addison Morgan to discuss the CFTC's September 4<sup>th</sup> enforcement action against Uniswap. Uniswap is the creator of one of the most popular decentralized exchanges in the DeFi industry. Now, this involves the CFTC claiming that through its DEX, Uniswap facilitated retail commodity transactions, by enabling consumers to buy and sell ERC-20 tokens that track the price movement of Bitcoin and Ether, and provide the holder a compound yield. Generally, about 2X to the upside if the price of Bitcoin and Ether increases. To the downside, if the price of those tokens decreases.

The CFTC characterized these tokens as leveraged tokens, and because only designated contract markets, which Uniswap is not, may provide leveraged or margin products. The basis of the CFTC's enforcement action was that Uniswap violated the Commodity Exchange Act, a fascinating enforcement action for a variety of reasons. I'm looking forward, Addison, to talking about this with you today.

Before we jump into the theory that the CFTC is pursuing in this enforcement action, perhaps you might explain to our listeners how index tokens work from a mechanical standpoint.

**Addison Morgan:**

Sure, Ethan. Thanks for having. The index tokens, and that's just a term we're referring to, or utilizing to refer to these digital assets. But the tokens that issue in the CFTC's enforcement action are —basically, ERC-20 tokens let you state it. But what they do is, ironically, they were created to mitigate the risk associated with the traditional margin futures trading that CFTC has regulated. So, how these tokens work is that you had an ERC-20 token, which is basically a tokenized representation of an underlying asset here. There being, BTC and ETH. So, it's not tokenized in the sense that these holders actually possess BTC and ETH. No, what they are possessing is a token that tracks the price movements of those digital assets.

Like you stated, Ethan, the tokens in this enforcement action were providing basically a 2X compounded yield to their holders. So, as BTC's price increases by 10%, the holders of this token, no matter what their kind of holding is in terms of amount, their holdings will increase by a corresponding 20%, and vice versa to the downside. This is a very cool product when you think about it conceptually, because if I were to try to kind of margin trade on my own, what would

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that require me to do? It would require me to deposit collateral, it would require me to monitor the market to determine whether or not price is approaching my liquidation risk. Where now, I might have to add more collateral to my position to prevent that from happening.

This product, just by holding the token itself, that's literally all you have to do, is hold the token. You will be provided this yield. The way that it prevents against liquidation risk is that the underlying kind of smart contract functional, and this is just a computer code now, it automatically rebalances your, basically, collateral. If I were to buy \$100 worth of this token, what would happen on the inside, so to speak. Is that, the smart contract would take that \$100, it would take it to a DeFi lending protocol. I think Index Coop, actually, for this product, they utilize Aave. Aave is a very popular kind of DeFi lending protocol in the space.

It would take that \$100, deposit in. You would get \$200 in exchange in Aave just lending to you. With that \$200, the smart contract will buy more Ethereum. This is all happening just by virtue of holding the token. This smart contract is going and buying more Ethereum. So now, instead of you having an \$100 Ethereum position, you now have a \$200 Ethereum position because the smart control takes your collateral, and basically, it created a collateralized debt position.

That is what's happening here, and it's distinctly different from what the CFTC usually regulates from a traditional margin standpoint.

**Ethan Ostroff:**

Yes, it's pretty interesting. I guess the big question is, whether or not these index tokens are a "leveraged" product, right?

**Addison Morgan:**

Yes, agree. I think, if we have to make a concession, I think the concession you can make and still kind of undermine the CFTC's theory is that, yes, these are leveraged tokens in the sense that they provide 2X exposure. The mechanism might be different than how margin trading traditionally happens. But yes, ultimately, in exchange for collateral, these holders of this token are receiving double their exposure.

**Ethan Ostroff:**

Right. So, double their exposure to the price movements of either BTC or ETH, right?

**Addison Morgan:**

Correct.

**Ethan Ostroff:**

So then, I guess another way to sort of think, or ask about it, or think about it is like, are they leveraged or margined within the meaning of the Commodity Exchange Act, right?

**Addison Morgan:**

For sure. That's where I would say, no. I think before we get into that, we just provide a brief overview of the elements of what the retail commodity transaction provision, what they require. So, they require a leveraged or margin product offer on basically a futures contract basis. So here, if you think about leverage, how we just explained it earlier and how this smart contract functionality basically does everything on your behalf. If you think about it, if you want to swap as the facilitator of these "retail commodity transactions" is neither providing leverage to the public. That's happening through Index Coop's old product.

Then obviously, secondly, they also are not providing the actual product. Their DEX simply acts as a facilitator, but they're not offering products to anyone. Those products are being offered by a third party here, Index Coop.

**Ethan Ostroff:**

Interesting. Are there explicit exclusions to this retail commodity transaction provision within the Commodity Exchange Act that are relevant here?

**Addison Morgan:**

For sure. So, you raise a good point about the actual delivery exception. That is a very important exception to the CFTC's theory, and one that they didn't really expound upon in the CFTC's enforcement action against Uniswap. But effectively, the way the CEA, the Commodity Exchange Act as a statute is built upon the theory, you can trade futures contracts. Meaning that I can agree to buy a bushel of wheat from Ethan at some price in the future. I will be exempt from this retail commodity transaction provision if within 28 days of Ethan purchasing that futures contract or me purchasing that futures contract with Ethan, Ethan actually delivers that bushel of wheat. The underlying commodity itself is actually put in Addison's possession.

Here, the actual delivery exception is very fascinating, because cryptography and the purchasing and selling of digital assets, and you know, Ethan, this virtually happens instantaneously. So, the idea that notwithstanding whether or not Uniswap is a designated contract markets, I think that's not even a dispute, it's not. But all of these transactions being facilitated on their DEX are effectuated through actual delivery, actually providing delivery of the product to the end user here, the consumers that are navigating the DEX.

Like I said, in the CFTC's enforcement order, they didn't really speak on. I mean, they definitely said that the underlying commodities will not deliver within 28 days, but we'll definitely get into this a little bit later. But if these tokens, the index token I'm referring to are actually commodities under the CEA, then yes, delivery happened instantaneously. So, they should not be subjected to the CEA on that basis.

**Ethan Ostroff:**

Interesting. My recollection is the CFTC has expounded on what actual delivery in this exception means in practice, right? There's been some interpretive guidance. There's an 11th Circuit decision in The Hunter Wise Commodities case. How does that guidance and that decision sort of fit into the theory we see in this enforcement action?

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**Addison Morgan:**

I would say, it's contrary to the theory. I'll just read so our subscribers are aware. This is an actual quote from a CFTC press release about their March 24 of 2020 final interpreter guidance of the retail commodity transaction provision. In there, they were primarily interpreting the actual delivery exception, which we are discussing now. They state, "Interpreting actual delivery as meaning, one, a customer securing possession and control over the entire quantity of the commodity, whether it was purchased on margin, or using leverage, or any other financing arrangement. Two, the ability to use the entire quantity of the commodity freely in commerce, away from any particular execution venue no later than 28 days from the date of the transaction, and at all times thereafter. Second, the offeror, and counterparty seller, including any of their respective affiliates, or other persons acting in concert with the offeror or counterparty seller on a similar basis do not retain any interest in legal right or control over any of the commodity purchased on margin, leverage, or other financial arrangement at the expiration of 28 days from the day of the transaction."

By the CFTC's own words, this enforcement action against Uniswap seems to be invalid and not rooted in what the CFTC's actual interpretation of this exception means. Like I just stated, if possession of the entire quantity of the commodity, and basically the facilitator of the transaction here, Uniswap, also cannot have any right in the commodity. Then, both of those elements are satisfied immediately once a consumer purchases these index tokens, or would have purchased these index tokens on Uniswap's DEX.

Secondly, you have a very interesting point about the Hunter Wise Commodities case, which is another case the CFTC actually relied upon in its enforcement action against Uniswap. Not Uniswap, but Bitfinex, way back, this might have been 2015 or 2016. There, Bitfinex is being subject to a CFTC enforcement action because, yes, traditional margin trading is actually going on on this platform. But in that Hunter Wise Commodities case, the 11<sup>th</sup> Circuit interprets actual delivery as denoting the act of giving real and immediate possession to the buyer or the buyer's agent, which is distinguishable from constructed delivery.

Which would entail, for example, in the auto finance industry, when you have the title, like if you just have a paper title, that's just constructed delivery in the eyes of the 11<sup>th</sup> Circuit. Actual delivery would be you having the actual vehicle that's being represented by that paper title. Like I said, the other commissioners in the CFTC, they pointed this out, but it seems to me, at least, that enforced matching against Uniswap clearly contravenes what the CFTC stated back in 2020.

**Ethan Ostroff:**

Interesting. Casting forward, trying to read the tea leaves, do we expect the industry to accept this theory and sort of operate going forward with the understanding that sort of regulation by enforcement should be considered the standard that applies? Or, do we think, perhaps, we're going to see litigation on this issue moving forward? It's interesting timing, having this discussion now, when we just had crypto.com through the SEC. Then, interestingly enough, crypto.com's affiliated derivatives exchange invokes this mechanism to get the CFTC and the SEC to provide a joint interpretation about whether or not a particular derivatives product is governed by one, the other, or both. What might we expect coming down the pipeline here?

**Addison Morgan:**

The crypto.com anecdote is a great segue because that will be the approach moving forward. Maybe not a request for a joint interpretation, but these theories will be contested because the space is just too novel. I think many people in the industry don't feel strongly about the technical understandings of either one of these regulatory agencies. From that standpoint, I think that, yes, the push moving forward will be litigation. I think the primary reason is just a misunderstanding of cryptography, like that actual delivery exception is a very important exception that either Congress, the courts, or accommodation of both will have to come in and really evaluate what actual delivery means within the DEX context.

There may be variants in other contexts, but in the DEX context, actual delivery is very important because, as you know, Ethan, what we really have here is a vicarious liability theory. Being imposed upon DEXes, kind of, I wouldn't say haphazardly. But when you look at what the CFTC has previously stated on these points, it seems like this is just a land grab to try to see if we can influence Congress. Once there is a federal regulatory framework instituted, to throw more power our way.

It's unfortunate, because I think that many people in the industry actually want to be regulated. More regulation will bring in more liquidity from traditional financial institutions who want to be in this space. But that just has not happened. I think, it also puts creative thinkers like those at Index Coop who created this product so that retail consumers could basically remove themselves from the litigation risk associated with traditional margin futures, right? Here, you just have to hold the token. That's it. You don't have to manage anything else, just hold the token. Through that, you provided this compounded yield.

I think moving forward, people in the industry, particularly the exchanges, they want clarity and there's really no clarity through regulation by enforcement. They're trying to decide whether or not certain existing business models will be feasible for them in the future. Regulatory enforcement just does not provide an arena for that. So, I noticed a long-winded answer to your question, but these issues are convoluted. I think to kind of sift through the noise, this is the action that the stakeholders will take.

**Ethan Ostroff:**

I think it's important to acknowledge that there wasn't unanimity amongst the CFTC. There were multiple dissents characterized in the enforcement action as pretextual and without any basis in tested law. Even the regulators, as we know, whether we're talking about the CFTC, or we're talking about the SEC, the regulators can't agree. So, it's a very difficult situation for stakeholders in this space right now because of just the overwhelming lack of clarity, and the playing field seemingly changing pretty rapidly and pretty consistently.

**Addison Morgan:**

Yes. I'll just say one more thing on that point. With the overturn of Chevron Deference, I think that's just another catalyst for stakeholders in this space to really move forward fervently and not really passively. I think the idea in 2024 that you're just going to interpret whatever you want to interpret, the way you want to interpret without that really strong shield that these regulators previously had, I think that will continue to be tested as well. But yes, I agree with your point. We

know all about regulation by enforcement and it'll be interesting to see how this all pans out, with it being an election year.

**Ethan Ostroff:**

Yes, totally agree. I mean, the Loper Bright decision, and generally speaking, changes significantly the entire way that these regulators are viewed by industry participants. So, expect to see a lot more litigation and a variety of different fronts on that. Addison, thanks again for joining me today. Really appreciate your thoughts on this interesting enforcement action.

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